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Perspectives on corporate finance and strategy

Value's changing look

Plus, wringing value from environmental, social, and governance programs; integrating climate risk into decision making; and avoiding snap judgments

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A note to readers

As the global climate becomes a top-of-mind risk issue, executives will need to make tough decisions about how to protect their investments in people, processes, and property. Given pushes from activist investors, regulators, and their own employees to "do good," how can companies establish strong environmental, societal, and governance programs and, better yet, create value from them? This issue of *McKinsey on Finance* is dedicated to exploring the links between sustainability and value creation, as well as the corporation's role in both preparing for and mitigating the effects of climate change. We hope you enjoy this and future issues.

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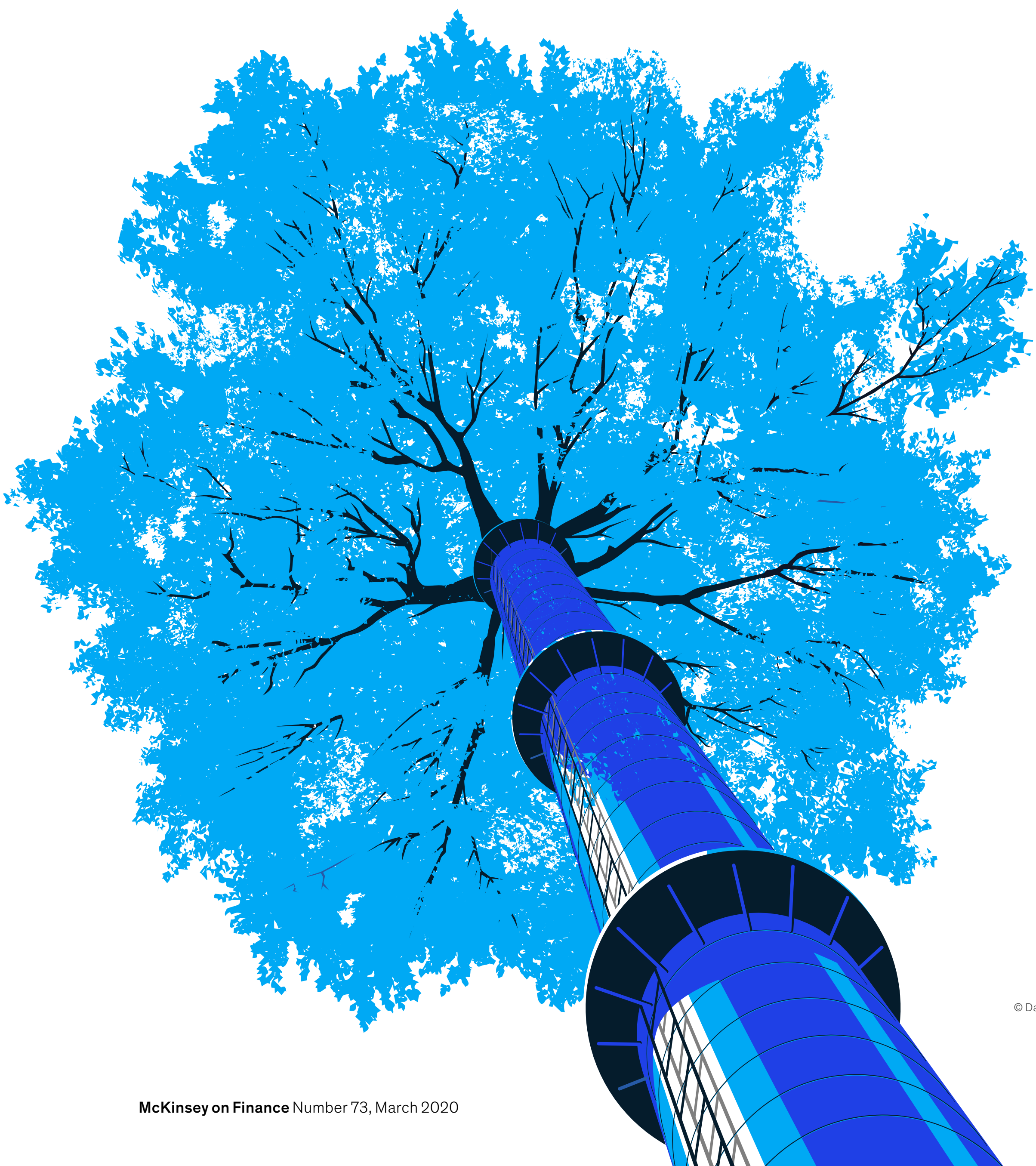
Five ways that ESG creates value

Getting your environmental, social, and governance proposition right links to higher value creation. Here's why.

by Witold Henisz, Tim Koller, and Robin Nuttall



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If it wasn’t entirely clear before, evidence is mounting that companies need to establish a strong proposition for managing environmental, social, and governance (ESG) concerns. Chief executives are embracing it as they publicly pledge to work on behalf of constituencies well beyond their traditional shareholders.[1] Research points to higher returns for companies with strong ESG propositions. And ESG-oriented investing is experiencing a meteoric rise. Global sustainable investment now tops $30 trillion—up 68 percent since 2014 and tenfold since 2004.[2]

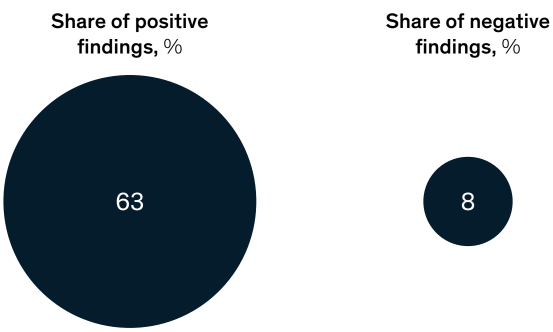
Still, many organizations are trying to make financial sense of ESG—how will emerging environmental, social, and governance concerns materially affect cash flows and value-creating activities? (See sidebar, “ESG—down to the letter.”) Our research and experience in the field point to five links between companies’ ESG propositions and their financial performance. Specifically, a strong ESG proposition can facilitate top-line growth, reduce cost, minimize regulatory and legal interventions, increase employee productivity, and optimize investment and capital expenditures.

Systematically thinking through ESG strategies can also help executives tap into the broad reputation and bottom-line benefits of a strong ESG profile.[3] Recent research demonstrates that a strong ESG proposition correlates with higher equity returns[4] as well as reduced downside risks, as evidenced, among other ways, by lower loan- and credit-default-swap spreads and higher credit ratings (Exhibit 1).[5]

Exhibit 1

Paying attention to environmental, social, and governance concerns does not compromise returns—rather, the opposite.

Results of >2,000 studies on the impact of environmental, social, and governance propositions on equity returns



Source: DWS; Gunnar Friede et al., “ESG and financial performance: Aggregated evidence from more than 2000 empirical studies,” *Journal of Sustainable Finance & Investment*, October 2015, Volume 5, Number 4, pp. 210–33; McKinsey analysis

1 See “Statement on the purpose of a corporation,” Business Roundtable, August 19, 2019, opportunity.businessroundtable.org.
2 *Global sustainable investment review 2018*, Global Sustainable Investment Alliance, April 2019, gsi-alliance.org.
3 The stakeholder approach is elaborated upon in John Browne, Robin Nuttall, and Tommy Stadlen, *Connect: How Companies Succeed by Engaging Radically with Society*, first edition, New York, NY: PublicAffairs, 2016; Witold J. Henisz, *Corporate Diplomacy: Building Reputations and Relationships with External Stakeholders*, first edition, New York, NY: Routledge, 2016; and Colin Mayer, *Prosperity: Better Business Makes the Greater Good*, first edition, Oxford, United Kingdom: Oxford University Press, 2018.
4 Mozaffar Khan, George Serafeim, and Aaron Yoon, “Corporate sustainability: First evidence on materiality,” *Accounting Review*, November 2016, Volume 91, Number 6, pp. 1697–724, aaapubs.org; Altaf Kassam, Linda-Eling Lee, and Zoltán Nagy, “Can ESG add alpha? An analysis of ESG tilt and momentum strategies,” *Journal of Investing*, Summer 2016, Volume 25, Number 2, pp. 113–24, joi.pm-research.com.
5 For example, see Witold J. Henisz and James McGlinch, “ESG, material credit events, and credit risk,” *Journal of Applied Corporate Finance*, July 2019, Volume 31, pp. 105–17, onlinelibrary.wiley.com; Erik Landry, Mariana Lazaro, and Anna Lee, “Connecting ESG and corporate bond performance,” MIT Sloan School of Management and Breckinridge Capital Advisors, 2017, mitsloan.mit.edu; Sara A. Lundqvist and Anders Vilhelmsson, “Enterprise risk management and default risk: Evidence from the banking industry,” *Journal of Risk and Insurance*, March 2018, Volume 85, Number 1, pp. 127–57, onlinelibrary.wiley.com; and Mitch Reznick and Michael Viehs, “Pricing ESG risk in credit markets,” Hermes Credit and Hermes EOS, Quarter 2 2017, hermes-investment.com. Similar benefits are found in yield spreads attached to loans; see Sung C. Bae, Kiyoung Chang, and Ha-Chin Yi, “Corporate social responsibility, credit rating, and private debt contracting: New evidence from syndicated loan market,” *Review of Quantitative Finance and Accounting*, January 2018, Volume 50, Number 1, pp. 261–99, link.springer.com; Sung C. Bae, Kiyoung Chang, and Ha-Chin Yi, “The impact of corporate social responsibility activities on corporate financing: A case of bank loan covenants,” *Applied Economics Letters*, 2016, Volume 23, Number 17, pp. 1234–7, tandfonline.com; Sudheer Chava, “Environmental externalities and cost of capital,” *Management Science*, September 2014, Volume 60, Number 9, pp. 2111–380, pubsonline.informs.org; and Allen Goss and Gordon S. Roberts, “The impact of corporate social responsibility on the cost of bank loans,” *Journal of Banking & Finance*, July 2011, Volume 35, Number 7, pp. 1794–810, sciencedirect.com.

Of course, corporate leaders should also acknowledge at the outset that hard trade-offs—and, yes, a long-term view—will be necessary. Companies must put ESG investments through their own cost-benefit analyses, just as they would do when allocating capital for any other purpose and striving for long-term-value creation. Not every link will apply—or apply to the same degree—in every business scenario. Some are more likely to arise in certain industries or sectors; others may be more frequent in given geographies. Still, the potential for value creation is too great to leave any of the five links unexplored. Our research and experience suggest there are plenty of win–win opportunities out there, if companies are willing to look long and hard enough.

Top-line growth

A strong ESG proposition can help companies tap new markets and expand into existing ones. When governing authorities trust corporate actors, they are more likely to award those actors the access, approvals, and licenses required for growth. In a recent, massive, public–private infrastructure project in Long Beach, California, for instance, the for-profit companies selected to participate were screened based on their prior performance in sustainability.[6] Superior ESG execution has demonstrably paid off in mining, as well. Consider gold, a commodity (albeit an expensive one) that should, all else being equal, generate the same rents for the companies that mine it, regardless of their ESG propositions. Yet one major study found that companies with social-engagement activities that public and social stakeholders perceived to be beneficial had an easier go at extracting those resources, without extensive planning or operational delays.[7] These companies achieved demonstrably higher valuations than competitors with lower social capital did.

ESG concerns can also drive consumer preference. McKinsey research has shown that customers say they are willing to pay to "go green."[8] Although there can be wide discrepancies in practice, including customers who refuse to pay even 1 percent more, we have found that upward of 70 percent of consumers surveyed on purchases in multiple industries, including the automotive, building, electronics, and packaging categories, said they would pay an additional 5 percent for a green product if it met the same performance standards as those of a nongreen alternative. In another study, 44 percent of companies we surveyed identified business and growth opportunities as the impetus for starting their sustainability programs.[9]

The payoffs are real. When Unilever developed Sunlight, a brand of dishwashing liquid that used much less water than its other brands, sales of Sunlight and Unilever's other water-saving products proceeded to outpace category growth by more than 20 percent in a number of water-scarce markets. And Finland's Neste, founded as a traditional petroleum-refining company more than 70 years ago, now generates more than two-thirds of its profits from renewable fuels and sustainability-related products.

Cost reduction

ESG plans can also help companies reduce costs substantially. Among other advantages, executing ESG propositions effectively can help combat rising operating expenses (such as raw-material costs and the true cost of water or carbon), which McKinsey research has found can affect operating profits by as much as 60 percent.[10] The authors of that report created a metric (the amount of energy, water, and waste used in relation to revenue) to analyze the relative resource efficiency of companies within various sectors

[6] Michael Della Rocca, "The rising advantage of public-private partnerships," July 2017, McKinsey.com.
[7] Sinziana Dorobantu, Witold J. Henisz, and Lite J. Nartey, "Spinning gold: The financial returns to stakeholder engagement," *Strategic Management Journal*, December 2014, Volume 35, Issue 12, pp. 1727–48, onlinelibrary.wiley.com.
[8] Mehdi Miremadi, Christopher Musso, and Ulrich Weihe, "How much will consumers pay to go green?," *McKinsey Quarterly*, October 2012, McKinsey.com.
[9] Achim Berg, Nils Schlag, and Martin Stuchtey, "Getting the most out of your sustainability program," August 2015, McKinsey.com.
[10] *McKinsey on Sustainability & Resource Productivity*, July 2014, McKinsey.com.

ESG—down to the letter

The E in "ESG" refers to environmental criteria, including the energy your company takes in, the waste it discharges, the resources it needs, and the consequences for living beings as a result. Not least, it encompasses carbon emissions and climate change. Every company uses energy and resources; every company affects, and is affected by, the environment.

The S in "ESG" refers to social criteria, addressing the relationships your company has and the reputation it fosters with people and institutions in the communities in which you do business. It includes labor relations, diversity, and inclusion. Every company operates within a broader, diverse society.

The G in "ESG" refers to governance, the internal system of practices, controls, and procedures your company adopts to govern itself, make effective decisions, comply with the law, and meet the needs of external stakeholders. Every company, which is itself a legal creation, requires governance.

All three are intertwined—for instance, social criteria overlap with environmental criteria and governance when companies seek to comply with environmental laws or address broader concerns about sustainability.

and found a significant correlation between resource efficiency and financial performance. The study also identified a number of companies across sectors that did particularly well—precisely those companies that had taken their sustainability strategies the furthest.

As with each of the five links to ESG value creation, the first step to realizing value begins with recognizing the opportunity. Consider 3M, which has long understood that being proactive about environmental risk can be a source of competitive advantage. Through its Pollution Prevention Pays (3P) program, the company has saved $2.2 billion since the program was introduced, in 1975, preventing pollution up front by reformulating products, improving manufacturing processes, redesigning equipment, and recycling and reusing waste from production. Another enterprise, a major water utility, achieved cost savings of almost $180 million per year thanks to lean initiatives aimed at improving preventive maintenance, refining spare-part-inventory management, and tackling energy consumption and recovery from sludge. And FedEx aims to convert its entire 35,000-vehicle fleet to electric or hybrid engines. To date, 20 percent have been converted, which has already reduced fuel consumption by more than 50 million gallons.[11]

Reduced regulatory and legal interventions

A strong external-value proposition can enable companies to achieve greater strategic freedom, easing regulatory pressure. In fact, in case after case across sectors and geographies, we have seen that strong ESG plans help reduce companies' risk of adverse government action. They can also engender government support.

[11] Witold J. Henisz, "The costs and benefits of calculating the net present value of corporate diplomacy," *Field Actions Science Reports*, 2016, Special Issue 14, journals.openedition.org.

The value at stake may be higher than you think. By our analysis, one-third of corporate profits are typically at risk from state intervention. Regulation's impact, of course, varies by industry. For pharmaceuticals and healthcare, the profits at stake are about 25 to 30 percent. For banking, where provisions on capital requirements, the "too big to fail" concept, and consumer protection are so critical, the value at stake is typically 50 to 60 percent. For automotive, aerospace and defense, and tech, where government subsidies (among other forms of intervention) are prevalent, the value at stake can reach 60 percent as well (Exhibit 2).

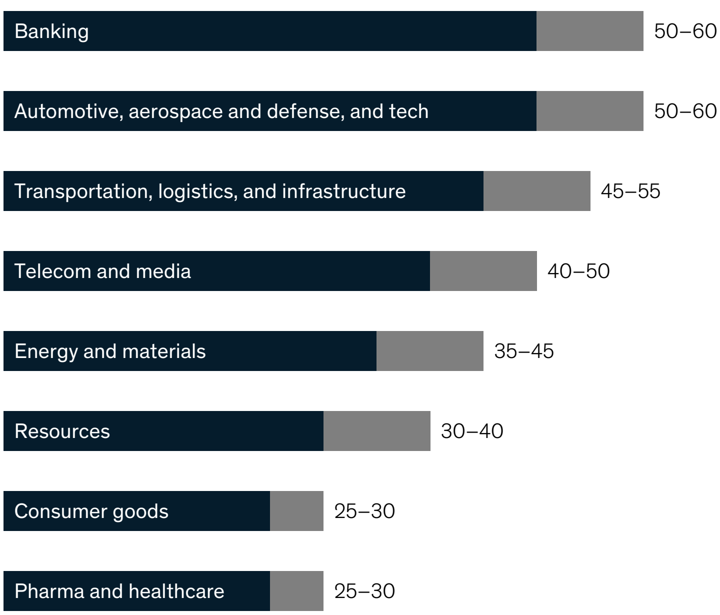
Employee-satisfaction and -productivity improvements

Strong ESG propositions can help companies attract and retain high-quality employees, enhance employee motivation by instilling a sense of purpose, and increase overall productivity. Employee satisfaction positively correlates with shareholder returns.[12] For example, London Business School's Alex Edmans found that the companies that made Fortune's 100 Best Companies to Work For list generated 2.3 to 3.8 percent higher stock returns per year than their peers did over a more than 25-year horizon.[13]

Exhibit 2

In many industries, a large share of corporate profits are at stake from external engagement.

Estimated share of EBITDA[1] at stake, %



Examples

Capital requirements, systemic regulation ("too big to fail"), and consumer protection

Government subsidies, renewables regulation, and carbon-emissions regulation

Pricing regulation and liberalization of sector

Tariff regulation, interconnection, fiber deployment, spectrum, and data privacy

Tariff regulation, renewables subsidies, interconnection, and access rights

Resource nationalism, mineral taxes, land-access rights, community reach, and reputation

Obesity, sustainability, food safety, health and wellness, and labeling

Market access, regulation of generic drugs, pricing, innovation funding, and clinical trials

[1] Earnings before interest, taxes, depreciation, and amortization.

[12] Alex Edmans, "Does the stock market fully value intangibles? Employee satisfaction and equity prices," *Journal of Financial Economics*, September 2011, Volume 101, Number 3, pp. 621–40, sciencedirect.com.
[13] Alex Edmans, "The link between job satisfaction and firm value, with implications for corporate social responsibility," *Academy of Management Perspectives*, November 2012, Volume 26, Number 4, pp. 1–19, journals.aom.org.

Recent studies have shown that positive social impact correlates with higher job satisfaction, and field experiments suggest that when companies "give back," employees react with enthusiasm.

Recent studies have also shown that positive social impact correlates with higher job satisfaction, and field experiments suggest that when companies "give back," employees react with enthusiasm. For instance, randomly selected employees at one Australian bank who received bonuses in the form of company payments to local charities reported greater and more immediate job satisfaction than did colleagues who were not selected for the donation program.[14]

Just as a sense of higher purpose can inspire your employees to perform better, a weaker ESG proposition can drag productivity down. The most glaring examples are strikes, worker slowdowns, and other labor actions within your organization. But remember that productivity constraints can also occur outside of your company, across the supply chain. Primary suppliers often subcontract portions of large orders to other companies or rely on purchasing agents, and subcontractors are typically managed loosely, sometimes with little oversight of workers' health and safety.

Far-sighted companies pay heed. Consider General Mills, which works to ensure that its ESG principles apply "from farm to fork to landfill." Walmart, for its part, tracks the work conditions of its suppliers, including those with extensive factory floors in China, using a proprietary company scorecard. And Mars seeks opportunities where it can deliver what it calls "win-win-wins" for the company, its suppliers, and the environment. Mars has developed model farms that not only introduce new technological initiatives to farmers in its supply chains but also increase farmers' access to capital so they can obtain financial stakes in those initiatives.[15]

Investment and asset optimization

A strong ESG proposition can enhance investment returns by helping companies allocate capital to more promising and more sustainable business opportunities (for example, renewables, waste reduction, and scrubbers). It can also help companies avoid stranded investments that may not pay off,

[14] Jan-Emmanuel De Neve et al., "Work and well-being: A global perspective," *Global Happiness Policy Report*, Global Happiness Council, February 2018, happinesscouncil.org.
[15] Katy Askew, "'Extended supply chains are broken': Why Mars thinks the commodities era is over," FoodNavigator, June 6, 2018, foodnavigator.com.

because of longer-term environmental issues (such as massive write-downs in the value of oil tankers). Taking proper account of investment returns requires that you start from the proper baseline, and when it comes to ESG, a do-nothing approach is usually an eroding line, not a straight line. Continuing to rely on energy-hungry plants and equipment, for example, can drain cash going forward.

The investments required to update your operations may be substantial—but choosing to wait it out can be the most expensive option of all. The rules of the game are shifting. Regulatory responses to emissions will likely affect energy costs and could especially affect balance sheets in carbon-intense industries. And bans or limitations on such things as single-use plastics and diesel-fueled cars in city centers will introduce new constraints on multiple businesses, many of which could find themselves having to play catch-up. One way to get ahead is to consider repurposing assets right now—for instance, by converting failing parking garages into uses with higher demand, such as residences or day-care facilities, a trend we are beginning to see in reviving cities.

The linkage from ESG plan to value creation is solid indeed. In particular, five levers across the bottom and top lines can be difference makers. In a world in which environmental, social, and governance concerns are becoming more urgent than ever, leaders should keep those connections in mind.

Portions of this article appear in *Valuation: Measuring and Managing the Value of Companies*, seventh edition (John Wiley & Sons, Spring 2020).

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Three principles for succeeding with your ESG strategy

The five links between value creation and environmental, social, and governance concerns are grounded in hard numbers, but, as always, leaders will need to use softer skills to execute their strategies.

by Witold Henisz, Tim Koller, and Robin Nuttall

With a clear understanding of the five ways that environmental, social, and governance (ESG) concerns can materially affect financial performance, leaders can revisit and revise their existing ESG strategies—or present evidence of the need for whole new ESG propositions in their companies. Particularly for leaders seeking out new ESG opportunities or trying to nudge an organization in directions that may feel counter to its traditional business model, here are a few personal points to keep in mind.

Get specific

It's important to understand the multiple ways that environmental, social, and governance factors can create value, but when it comes to inspiring those around you, what will you really be talking about? Surprisingly, that depends. The individual causes that may inspire any one of us are precisely that—individual. The issues most important to executives on your team could incline in any number of directions. Large companies can have dozens of social, community, or environmental projects in motion at any time. Too many at once can be a muddle; some may even work at cross-purposes.

In our experience, companies should articulate a few priority initiatives—typically, no more than five. To decide which ones and to get the most out of them, let the company be your guide. One leading agribusiness, for instance, is channeling its capabilities into addressing hunger. The company has been able to tap its well-honed competencies to work with farmers in emerging regions to diversify their crops and adopt new technologies, which increases production and strengthens the company's ties with different countries and communities.

Get practical

Value creation should be the CEO's core message. Anything else could sound off key. Managers, especially more senior ones, are usually assessed based on performance targets. Under those conditions, top-down ESG pronouncements can seem distracting or too vague to be of much use. "Save the planet" won't cut it. To get everyone on board, make the case that your ESG priorities do link to value and show leaders how, ideally with hard metrics that feed into your business model—for example, output per baseline electricity use, waste cost in a given plant or location per employee, and revenue per calorie for a food-and-beverage business. The case will be simpler if you have done the hard work to analyze what matters along your value chain, where the greatest potential lies, and which areas have the most impact for your company. Proactive companies carefully research potential initiatives, including by tapping thought

It's important to understand the multiple ways that environmental, social, and governance factors can create value, but when it comes to inspiring those around you, what will you really be talking about?

leaders and industry experts; iterate their findings with internal and external stakeholders; and then publish the results. Making the case publicly—not least to investors—enforces rigor and helps ensure that practical actions will follow.

Get real

An honest appraisal of an ESG plan should include acknowledgment that getting it wrong can result in value destruction. Being perceived as overdoing it can sap a leader's time and focus. Underdoing it can be even worse. Companies that perform poorly in ESG criteria are more likely to endure adverse events. Just in the past few years, multiple companies with weak ESG propositions saw double-digit declines in market capitalization in the days and weeks after their missteps came to light.[1]

Leaders should assess the value at stake from external engagement (in our experience, poor external engagement can typically destroy about 30 percent of value) and plan scenarios for potential hits to operating profits. These days, such events can seem to come out of nowhere—even from a single tweet. Playing fast and loose with ESG issues is playing to lose, and failure to confront downside risk can be disastrous.

Conversely, being thoughtful and transparent about ESG risk enhances long-term value—even if doing so can feel uncomfortable and effect some short-term pain. Ed Stack, the CEO of North American retailer DICK'S Sporting Goods, said he expected that the company's 2018 announcement to restrict gun sales would alienate some customers, and he was right: by his own estimate, the announcement cost the company $150 million in lost sales, or slightly less than 2 percent of yearly revenue. Yet the company's stock climbed 14 percent in a little more than a year following the shift.

One reason for the resilience of DICK'S Sporting Goods may be that gun sales were already a declining part of the company's portfolio. Another reason is that it remained committed to its sense of purpose. Researchers have found that companies' market capitalization increases with stakeholder support, particularly in times when peer stakeholders criticize or attack company operations.[2]

Holding to your company's central values is particularly essential today, as polarization widens society. "Fueled in part by social media, public pressures on corporations build faster and reach further than ever before," BlackRock's Larry Fink observed in his 2019 letter to CEOs.[3] Fink argued that "As divisions continue to deepen, companies must demonstrate their commitment to the countries, regions, and communities where they operate."

Walking the talk on purpose strengthens the company and its community. "Profits," Fink notably concludes, "are in no way inconsistent with purpose—in fact, profits and purpose are inextricably linked."

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[1] Witold J. Henisz and James McGlinch, "ESG, material credit events, and credit risk," *Journal of Applied Corporate Finance*, Spring 2019, Volume 31, Number 2, pp. 105–17, onlinelibrary.wiley.com.
[2] Sinziana Dorobantu, Witold J. Henisz, and Lite Nartey, "Not all sparks light a fire: Stakeholder and shareholder reactions to critical events in contested markets," *Administrative Science Quarterly*, September 2017, Volume 62, Number 3, pp. 561–97, journals.sagepub.com.
[3] Larry Fink, "Larry Fink's 2019 letter to CEOs: Purpose & profit," BlackRock, 2019, blackrock.com.

The ESG premium: New perspectives on value and performance

In a new survey, executives and investment professionals largely agree that environmental, social, and governance programs create short- and long-term value—though perceptions of how have changed over the past decade.

Pressure on companies to pay attention to environmental, social, and governance (ESG) issues continues to mount. Researchers, business groups, and nongovernmental organizations have variously warned of the risks—or emphasized the opportunities—that such issues present to company performance.[1] Most executives and the investment professionals who scrutinize their companies seem to agree that ESG programs affect performance. In our latest McKinsey Global Survey on valuing ESG programs,[2] 83 percent of C-suite leaders and investment professionals say they expect that ESG programs will contribute more shareholder value in five years than today. They also indicate that they would be willing to pay about a 10 percent median premium to acquire a company with a positive record on ESG issues over one with a negative record. That's true even of executives who say ESG programs have no effect on shareholder value.

Among respondents who say such programs increase shareholder value, perceptions of how the programs do so have shifted since our survey on the subject in 2009.[3] A majority of these business leaders and investment professionals now say environmental, social, and governance programs individually create value over both the short term and the long term. Moreover, the perceived long-term value of environmental and social programs now rivals or exceeds the value attributed to governance programs.

What follows is a closer look at how perspectives have changed with respect to several topics, including the impact of ESG issues on shareholder value and financial performance, the reasons companies prioritize ESG programs, and the challenges and opportunities in ESG data and reporting.

ESG programs and shareholder value

A majority of surveyed executives and investment professionals (57 percent) agree that ESG programs create shareholder value. That share is largely consistent with responses to the survey a decade ago, as well as across most demographic categories—job title, company size, company ownership (public or private), and geography—in the present survey. Respondents in consumer-focused companies are more likely (66 percent) than those in B2B companies (56 percent) to say these programs create value.

A small minority remains unconvinced. Just 3 percent of respondents believe such programs reduce shareholder value, and 14 percent say they are unsure. That level of uncertainty is significantly lower than the 25 percent of respondents who were uncertain in 2009, but the shift corresponds to an increase in the proportion of respondents who say ESG programs have no effect on shareholder value—now at 25 percent, up from 14 percent in 2009. Much of this increase is because of the higher proportion of investment professionals reporting that the programs have no effect.

These findings come as 58 percent of respondents tell us that the current political environment has increased the importance of ESG programs to meet stakeholder expectations. In addition, about four in ten say the political environment has increased the importance of ESG programs to shareholder value.

[1] "Statement on the purpose of a corporation," Business Roundtable, August 2019, opportunity.businessroundtable.org; *Community development innovation review: Strategies to address climate change risk in low- and moderate-income communities*, October 2019, Volume 14, Number 1, frbsf.org; *Report of the Secretary-General on the 2019 Climate Action Summit and the way forward in 2020*, United Nations, December 11, 2019, un.org.

[2] The online survey was in the field from July 16 to July 31, 2019, and garnered responses from 558 participants representing the full range of regions, industries, and company sizes. Of these respondents, 439 are C-suite executives and 119 are investment professionals. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

[3] "Valuing corporate social responsibility," February 2009, McKinsey.com. The 2009 survey garnered responses from 238 participants. Of these respondents, 84 were CFOs and 154 were investment professionals. Given the relative novelty of environmental, social, and governance (ESG) issues in 2009, that survey sample included only CFOs as the executives most likely to be familiar with the practice of ESG valuation. That is no longer the case. As a result, the 2019 survey sample also included CEOs, COOs, and other C-level executives with responsibility for sustainability or corporate social responsibility. All of the reported comparisons between the 2009 and 2019 data remained directionally consistent when controlling for the difference in the samples, and all but two were statistically significant; those instances are marked.

Among respondents who say ESG programs add value, perspectives have shifted since 2009 (Exhibit 1). The survey asked separately about environmental, social, and governance programs over the long and short term. For each type of program and each time horizon, the proportion of these respondents perceiving value creation has increased, with the greatest increases seen in social programs. Respondents are likelier to say each type of program contributes long-term value than short-term value, as was true in 2009—which may reflect the initial costs associated with investing in some ESG programs.

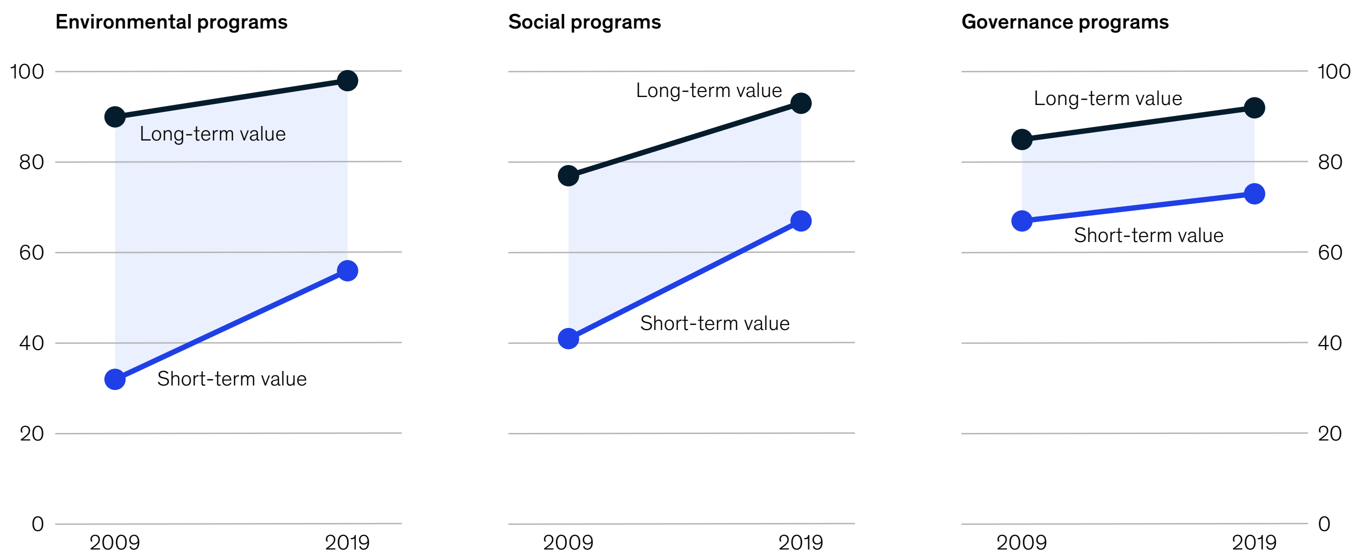
Respondents who say ESG programs add value are now nearly unanimous in perceiving long-term value from environmental programs. Social and governance programs approach the same levels, with 93 percent saying social programs make a positive long-term contribution, compared with 77 percent in 2009. Similarly, the share of executives saying governance programs have positive long-term contributions has grown since the previous survey. Now executives are about as likely as investment professionals (about 90 percent of each) to say governance programs have a positive long-term contribution, which was not true in the previous survey.

Among respondents who see value from ESG programs, a majority now say these programs add shareholder value in the short term. Two-thirds of these respondents say social programs add value in the short term, up from 41 percent ten years ago. Just over seven in ten say governance programs have a positive short-term effect, compared with 67 percent who said so previously.[4] Since 2009, the proportion of investment professionals who report a positive impact from governance programs has held steady, and now they and executives are about equally likely to say the programs have a positive short-term impact.

Exhibit 1

Among respondents who say environmental, social, and governance programs create value, the share seeing short- and long-term value has grown.

Share of respondents who say given program creates value, %[1]



[1] Question was asked only of respondents who said environmental, social, and governance programs increase shareholder value. Respondents who said "substantially negative," "negative," or "no effect" are not shown; total n = 136 in 2009 and n = 342 in 2019.

[4] This difference was not statistically significant when controlling for the different roles included in the 2009 and 2019 survey samples.

Whether or not respondents believe ESG programs create value today, their expectations of future value are reflected in how they account for a positive ESG-program record when comparing hypothetical M&A deals. Given a hypothetical opportunity to acquire a new business, respondents across the spectrum say they would be willing to pay about a 10 percent premium for a company with an overall positive record on ESG issues over a company with an overall negative record. That median value is relatively consistent between CEOs and other C-level executives, as well as among respondents with various office locations and company focuses, sizes, and ownership structures.

The distribution of responses was wide, however. Some pockets of respondents anticipate extraordinary value from positive records with ESG programs. One-quarter of respondents say they would be willing to pay a premium of 20 to 50 percent, and 7 percent say they would pay a premium of more than 50 percent.[5] Even those who say ESG programs don't increase shareholder value are willing to pay 10 percent more for a company with a positive record, while the median among those who say ESG programs increase value for shareholders is a premium of 15 percent.

ESG programs' contributions to financial performance

Maintaining a good corporate reputation and attracting, motivating, and retaining talent continue to be cited most often as ways that ESG programs improve financial performance, though other perceptions of ESG programs' effects have shifted since the previous survey (Exhibit 2). Respondents who say ESG programs increase shareholder value are more likely now than a decade ago to say the top ways the programs improve financial performance

Exhibit 2

Perceptions have shifted in the past decade on how environmental, social, and governance programs contribute to financial performance.

Top ways that environmental, social, and governance programs improve financial performance, % of respondents[1]

[1] Question was asked only of respondents who said environmental, social, and governance programs increase shareholder value. Executives were asked which ways ESG programs improve their organizations' financial performance, and investment professionals were asked which ways ESG programs improve organizations' financial performance. Respondents who said "other" or "don't know" are not shown; total n = 136 in 2009 and n = 342 in 2019.
[2] Not statistically significant when controlling for the different roles included in the 2009 and 2019 survey samples.

[5] Figures were calculated after removing respondents who said "don't know/prefer not to answer" (21 percent of total responses).

include strengthening the organization's competitive position[6] and meeting society's expectations for good corporate behavior. In a separate question asked of respondents who say ESG programs increase shareholder value, more than half say the existence of high-performing ESG programs is a proxy for good management, in line with the 2009 findings.

The survey also asked all respondents which aspects of ESG-related activities are most important. The largest share cite compliance, and they are likelier to say so now than in 2009 (Exhibit 3). Respondents are less likely now than in the previous survey to identify changing business processes to incorporate good ESG practices as most important. Notably, responses among investment professionals and executives are relatively similar.

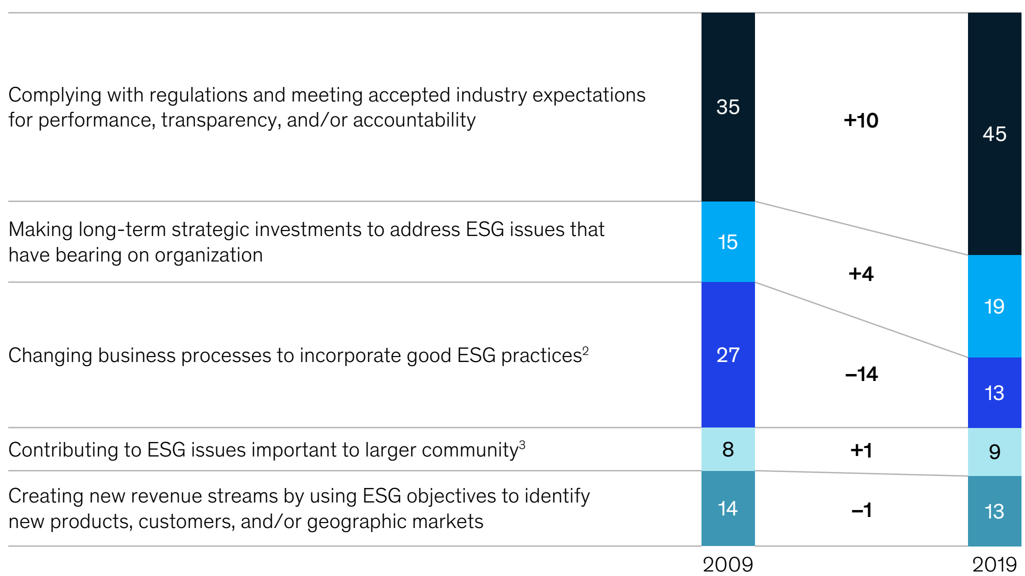
Considering ESG factors in strategic and operational decisions

Executives and investment professionals indicate that they commonly take ESG issues into consideration when making strategic and operational decisions. More than seven in ten respondents say they—or, in the case of executives, their organizations—somewhat or fully consider ESG issues in their assessments of a company's competitors and its supply chain. And nearly eight in ten say they at least somewhat consider ESG issues in their assessments of potential capital projects.

Exhibit 3

Respondents are more likely than in 2009 to say complying with regulations and industry expectations is the most important aspect of environmental, social, and governance activities.

Environmental, social, and governance (ESG) activity ranked as most important, % of respondents[1]



[1] Respondents who said "other" or "don't know" are not shown; total n = 238 in 2009 and n = 573 in 2019.
[2] For example, changes to purchasing or performance-management systems and redesign of factory processes to minimize waste.
[3] That is, through charitable giving or philanthropy, product donations, and/or support for employee volunteering.

[6] This difference was not statistically significant when controlling for the different roles included in the 2009 and 2019 survey samples.

When asked whether they or their organizations track the impact of ESG programs on various stakeholder groups, respondents indicate that they consider a variety of stakeholders (Exhibit 4). About half of respondents report considering the impact on board directors, regulators, and investors entirely or to a great extent. Roughly one-third report considering the impact on industry peers, groups, and associations; prospective employees; and nongovernmental organizations. Compared with executives, investment professionals indicate that they consider the impact of ESG programs on a far broader swath of stakeholders. While board directors are the only stakeholders that more than half of executives say their organizations consider, more than half of investment professionals say they take into account the programs' impact on board directors, communities, investors, prospective customers, and regulators.

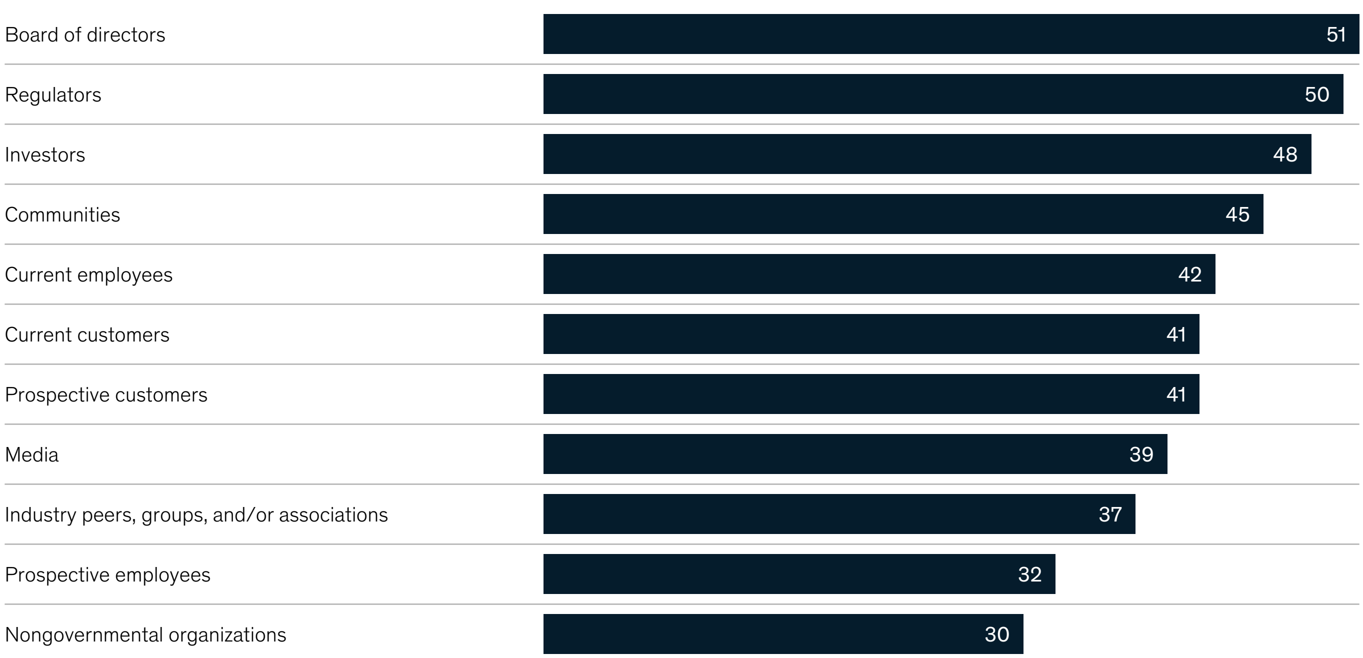
A quest for meaningful ESG data and reporting

The share of all respondents saying ESG reporting standards and frameworks are useful for interpreting ESG programs' value has increased

Exhibit 4

Respondents consider the impact of environmental, social, and governance programs on a breadth of stakeholders.

Stakeholder groups considered entirely or to a great extent, % of respondents[1]



[1] Executives were asked to what extent their organizations track the impact that their environmental, social, and governance programs have on each stakeholder group, and investment professionals were asked to what extent they include in their valuations the impact that companies' ESG programs have on each stakeholder group. Respondents who said "not at all," "somewhat," and "don't know" are not shown; total n = 558.

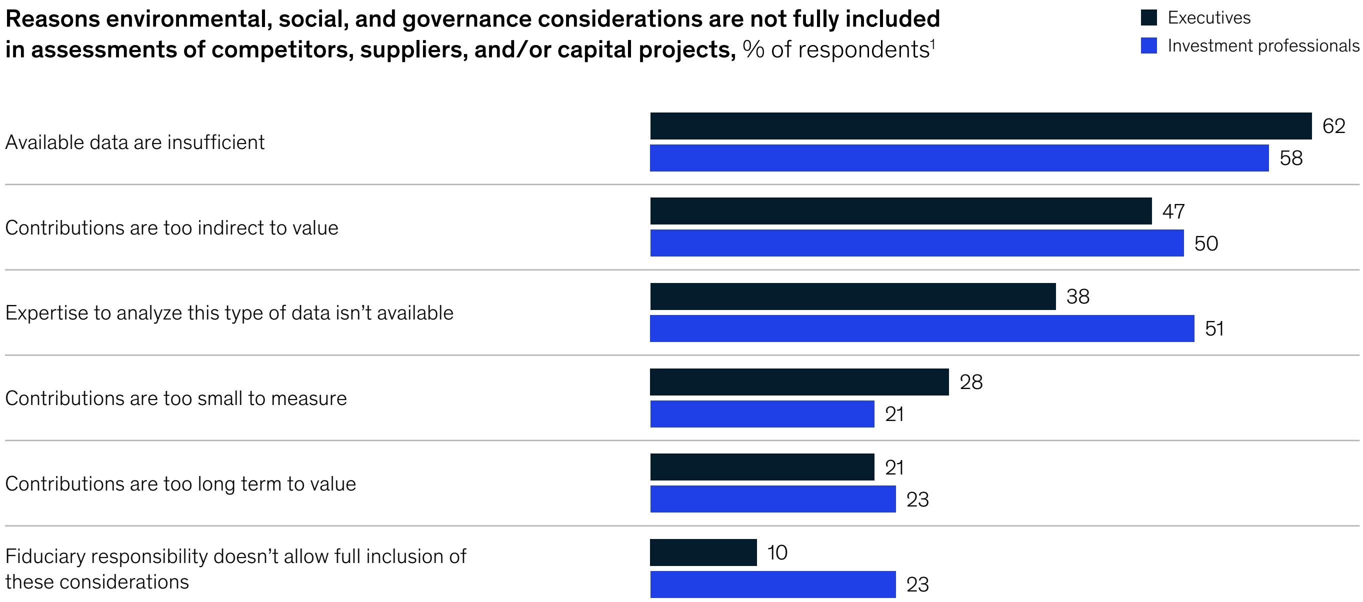
by 15 percentage points since 2009. Nevertheless, when we asked investment professionals and executives who report that their organizations do not fully include ESG considerations in assessments of competitors, suppliers, and major capital markets why they don't do so, both groups most often cite insufficient available data (Exhibit 5).[7] Other top reasons relate to the usability of data: contributions are too indirect to value, or analytic expertise is lacking.

Not surprisingly, then, when asked to identify the most important features of ESG reporting systems, respondents most often cite quantification of the financial impact of ESG programs (53 percent) and measurement of business opportunities and risks (47 percent). The third most cited feature, noted by 40 percent of respondents, is a consistent set of industry-specific metrics. This may explain why the systems most often considered valuable by investment professionals are reporting frameworks and standards, as well as certification or accreditation standards, such as SA8000.[8] By contrast, indexes produced by polling, media, and PR companies are the least likely to be considered valuable; two-thirds of investment professionals say the indexes are not valuable or only somewhat valuable.

Exhibit 5

Respondents largely cite data availability and usability as reasons for not considering environmental, social, and governance issues in assessments of competitors, suppliers, or capital projects.

Reasons environmental, social, and governance considerations are not fully included in assessments of competitors, suppliers, and/or capital projects, % of respondents[1]



[1] Question was asked only of executives who said their organizations somewhat or do not include environmental, social, and governance considerations in their assessments of competitors, suppliers, and/or major capital projects and of investment professionals who said they do not include ESG considerations in their assessments. Respondents who said "other" or "don't know" are not shown. For executives, n = 414; for investment professionals, n = 110.

[7] The question was asked only of the 414 executives who said their organizations somewhat or do not include ESG considerations in their assessments of competitors, suppliers, and/or major capital projects and of the 110 investment professionals who said they do not include ESG considerations in their assessments.

[8] The systems presented as answer choices were indexes developed by financial-index companies; rankings and/or data on socially responsible investing; indexes produced by media, polling, or PR companies; brand rankings; certification or accreditation standards; reporting frameworks and standards; voluntary industry standards; and learning networks.

When we asked which aspects of tools would most improve communication between organizations and investors or analysts, the largest share of investment professionals cite integrated corporate reports that include corporate financial data and financial and other data on ESG programs. While half of these respondents say integrated reports would have the most impact, just one-third of executives say the same (Exhibit 6).

Looking ahead

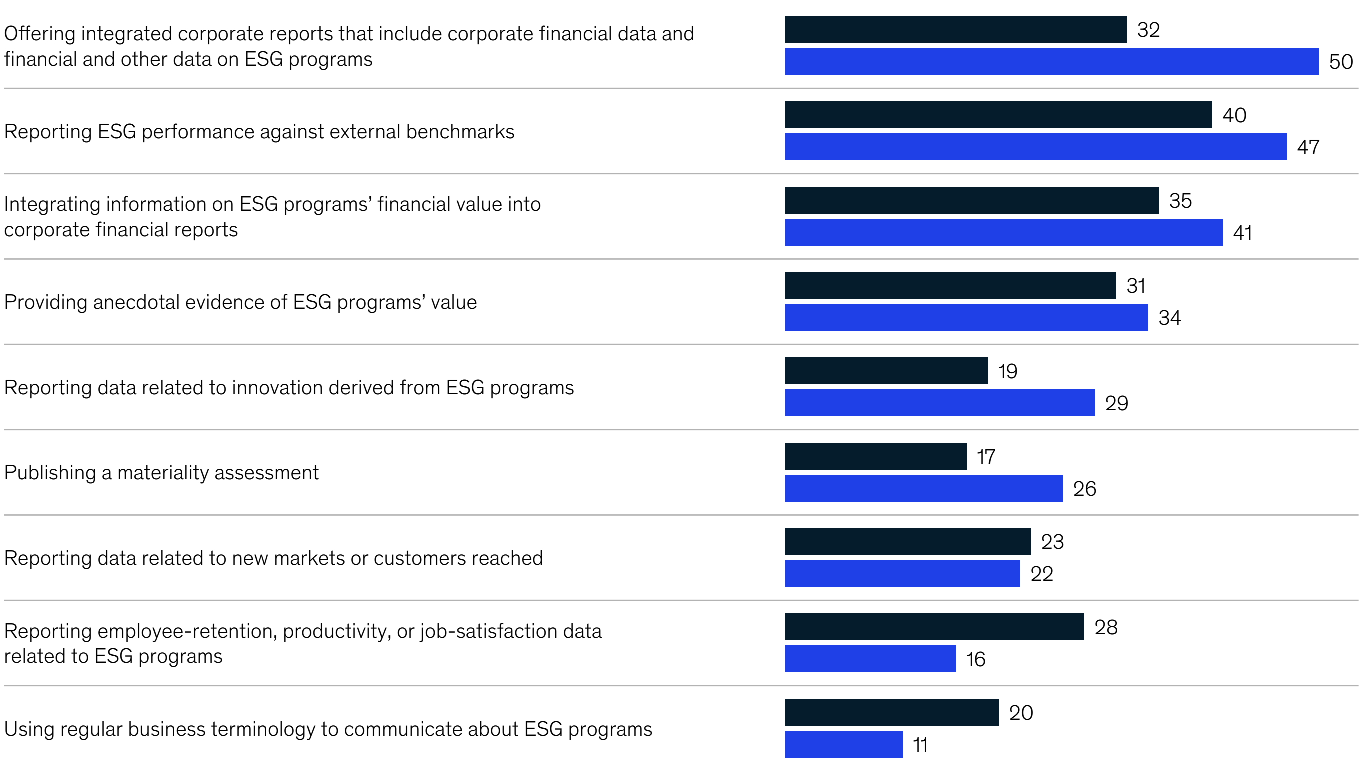
Executives and investment professionals today largely recognize that ESG issues can affect company performance, and the financial impact of ESG programs is likely to increase as expectations and scrutiny from investors, consumers, employees, and other stakeholders continue to grow. Even in industries that have exhibited more complicated records with ESG programs, taking

Exhibit 6

Executives and investment professionals differ most on the utility of integrated reports as a tool to improve communication between them.

Tactics that would most improve communication between organizations and investors or analysts about environmental, social, and governance (ESG) programs' performance, % of respondents[1]

Executives
Investment professionals



[1] Respondents who said "other," "none of the above," or "don't know" are not shown. For executives, n = 439; for investment professionals, n = 119.

action in these areas may help companies navigate rising pressure from stakeholders and distinguish themselves from competitors—positioning them to create more value.

Burgeoning interest in companies' ESG performance has resulted in a proliferation of reports, rankings, requests from investors and analysts, and other mechanisms for transparency. The responses to this survey show a fairly universal desire from investors and executives to improve the current approaches and create easier-to-use ESG metrics and data standards. It isn't possible—or worthwhile—to report on everything, but companies can focus on communicating the most critical information in ways that key stakeholders value. Investment professionals, especially, want ESG data that are more standardized, better integrated with financial data, and readily benchmarked. Such data could also benefit ESG leaders within companies, who might use the data to catalyze change internally. For example, the scenario planning required by the Task Force on Climate-Related Financial Disclosures (TCFD) standards can help with managing climate-change risks.

We know from previous research that strong performance on ESG issues can improve top-line growth, reduce costs, minimize regulatory and legal interventions, improve employee productivity, and focus investment and capital expenditures.[9] Respondents' willingness to pay a premium for companies with strong ESG-program performance and the belief that such performance is associated with overall management quality suggests that more investors and executives will incorporate ESG concerns into their financial and strategic decisions. If the shifts that have taken place over the past decade are a preview of the decade ahead, the value of ESG consideration will continue to grow. Companies that have not fully committed to ESG programs may leave value on the table.

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They wish to thank Anne-Titia Bové, Avery Cambridge, and Dennis Swinford for their contributions to this work.

[9] Witold Henisz, Tim Koller, and Robin Nuttall, "Five ways that ESG creates value," *McKinsey Quarterly*, November 2019, McKinsey.com.

Climate risk rises to the top of the business agenda

New research shows that companies must adapt more quickly, and at greater scale, as the effects of climate change materialize up and down supply chains.

by Mekala Krishnan, Dickon Pinner, and Jonathan Woetzel

Recent McKinsey Global Institute (MGI) research has put a distinct frame around the hazards from climate change: they're increasing in frequency and intensity, they remain unpredictable, and—ready or not—they're here. Scientists note that the five warmest years on record have all occurred since 2014, making 2019 the end of the hottest decade in recorded history.[1]

Meanwhile, employees, investors, suppliers, and other key corporate stakeholders are experiencing the effects of climate change on both a personal and a professional level. They have lots of questions: How are companies taking climate into account when they allocate capital, site new plants, develop new products or services, manage the supply chain, and set employee-travel policies?

The message to senior finance and business leaders is clear: just as thinking about information systems and cyberrisks has become part of your discussions and decisions about strategy and operations, so must climate change—and sooner rather than later. Neglecting climate risk may put you and your company in the crosshairs—as your business, for instance, allocates capital to risky assets in risky geographies or increases the likelihood that stakeholders will be caught unprepared. Conversely, your company may miss opportunities emerging from a changing climate—new places to target for agricultural production or tourism, for instance, or the chance to capitalize on new technologies and approaches to risk management.

MGI's report shows that business leaders must focus on three action items: use the right tools, analytics, processes, and governance models to assess climate risk properly; adapt to the climate risk locked in over the next decade; and, ultimately, decarbonize to zero net new emissions to stop the further buildup of risk. In this article, we explore the first two action items and suggest ways for executives to start thinking about climate risk in the context of their broader decision making.[2]

Accurately assess risk

One of the biggest challenges business leaders face in assessing climate risk is understanding which models to use. Current risk-assessment models, for instance, may not sufficiently account for geospatial dimensions: our research highlights the reality that the direct effects of climate change are local in nature, so companies will need to understand how their global asset footprints are exposed to different climate hazards in each of their main locations and, indeed, in each of the main locations of their critical suppliers.

Similarly, given constant climate change—or what we call "nonstationarity"—the assumptions business leaders base on historical precedent and experience will need to be rethought; that could include, for example, how resilient to make new factories or which tolerance levels to require in new infrastructure. Decisions will need to take into consideration the fact that the climate will continue to change over the next several decades. What's more, decision makers can no longer rely simply on their own experiences as a frame; instead, they will need to reach out to public- and private-sector partners for best practices and to external resources (such as the International Energy Agency or the Intergovernmental Panel on Climate Change) for data related to climate risk. Some regulators are even requiring companies to undergo financial stress tests to assess their exposure to climate risk.[3]

Don't wait to adapt

Our research points to the need for adaptations and climate-risk management in several critical areas: protecting people and assets, building operational resilience, reducing exposure, and ensuring appropriate insurance and financing.

In the area of resilience, for instance, companies may want to protect themselves against interrupted production by building up inventory levels in their

[1] Carolyn Gramling, "2019 was the second-warmest year on record," *Science News*, January 15, 2020, sciencenews.org.
[2] "Climate risk and response: Physical hazards and socioeconomic impacts," McKinsey Global Institute, January 2020, McKinsey.com.
[3] Philipp Härle, Efstathia Koulouridi, Aleksander Petrov, Luisa Quetti, and Lorenzo Serino, "Strategy at the stress-testing table for UK banks and beyond," November 2017, McKinsey.com.

supply chains or establishing ways to source from alternate locations or suppliers. As for exposure, companies will have to consider the full life cycles of their physical assets when making capital-expenditure decisions, acknowledging that it may eventually be necessary to redesign or relocate assets that become too difficult to protect.

Our research also suggests that significant adaptations will be required for insurance and financing. Studies show that today, only 50 percent of losses are insured.[4] This kind of underinsurance may grow worse, as more extreme events unfold, because fewer organizations carry insurance for them. Without insurance as a shock absorber, recovery after disaster becomes harder and knock-on effects more likely.[5] The introduction of climate-adjusted instruments, such as parametrized insurance and catastrophe bonds, may help address this issue. So will climate-aware approaches to underwriting and funding.

Executives must move quickly across all these dimensions, however: as the intensity of climate-related hazards increases, a company's ability to respond may become ever more restrained by economic, technical, or other limits. Difficult trade-offs will need to be assessed. In some instances, multiple stakeholders may have to take coordinated action, such as mandating insurance or disclosures for certain types of projects, mobilizing capital through risk-sharing mechanisms, sharing best practices in climate-risk management across industry groups, and promoting innovation.

Today, climate-related risk is a feature of global business, not a bug. Business leaders must start now to integrate climate risk into strategy conversations and decisions—all the while recognizing that their efforts may not show immediate returns. It takes time, after all, to battle through organizational inertia and make significant shifts in mind-sets and practices. And of course, new climate threats will emerge. In any case, business leaders need to make concerted efforts to ensure that they're developing thriving, adaptable, sustainable financial and socioeconomic systems.

This article is adapted from *Climate risk and response: Physical hazards and socioeconomic impacts*, McKinsey Global Institute, January 2020, McKinsey.com.

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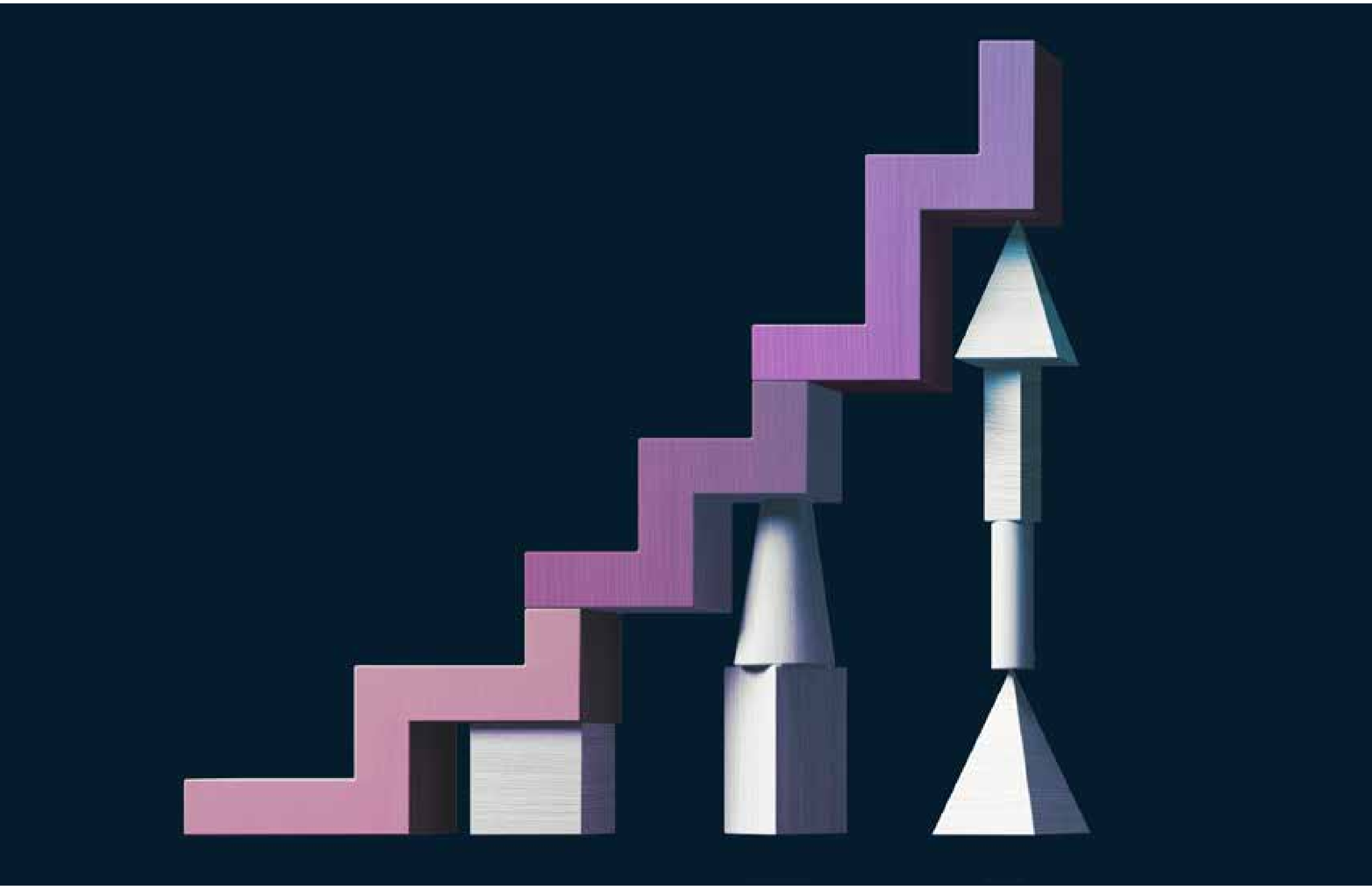
[4] Lucia Bevere et al., "Natural catastrophes and man-made disasters in 2018: 'Secondary' perils on the frontline," *sigma*, April 2019, Number 2, swissre.com; *Global modeled catastrophe losses*, AIR Worldwide, November 2018, air-worldwide.com.
[5] Sweta Saxena, Sebastian von Dahlen, and Goetz von Peter, *Unmitigated disasters? New evidence on the macroeconomic cost of natural catastrophes*, Bank for International Settlements working paper, number 394, December 2012, bis.org.

The value of value creation

Long-term value creation can—and should—take into account the interests of all stakeholders.

by Marc Goedhart and Tim Koller



Challenges such as globalization, climate change, income inequality, and the growing power of technology titans have shaken public confidence in large corporations. In an annual Gallup poll, more than one in three of those surveyed express little or no confidence in big business—seven percentage points worse than two decades ago.[1] Politicians and commentators push for more regulation and fundamental changes in corporate governance. Some have gone so far as to argue that "capitalism is destroying the Earth."[2]

This is hardly the first time that the system in which value creation takes place has come under fire. At the turn of the 20th century in the United States, fears about the growing power of business combinations raised questions that led to more rigorous enforcement of antitrust laws. The Great Depression of the 1930s was another such moment, when prolonged unemployment undermined confidence in the ability of the capitalist system to mobilize resources, leading to a range of new policies in democracies around the world.

Today's critique includes a call on companies to include a broader set of stakeholders, beyond just their shareholders, in their decision making. It's a view that has long been influential in continental Europe, where it is frequently embedded in corporate-governance structures. The approach is gaining traction in the United States as well, with the emergence of public-benefit corporations, which explicitly empower directors to take into account the interests of constituencies other than shareholders.

Particularly at this time of reflection on the virtues and vices of capitalism, we believe it's critical that managers and board directors have a clear understanding of what value creation means. For today's value-minded executives, creating value cannot be limited to simply maximizing today's share price. Rather, the evidence points to a better objective: maximizing a company's value to its shareholders, now and in the future.

Answering society's call

Recently, the Business Roundtable released its 2019 "Statement on the purpose of a corporation."[3] Dozens of business leaders (the managing partner of McKinsey among them) declared "a fundamental commitment to *all* of our stakeholders [emphasis in the original]." Signatories affirmed that their companies have a responsibility to customers, employees, suppliers, communities (including the physical environment), and shareholders. "We commit to deliver value to all of them," the statement concludes, "for the future success of our companies, our communities, and our country."

A focus on the future

The Business Roundtable's focus on the future is no accident: issues such as climate change and income inequality have raised concerns that today's global economic system is shortchanging the future. We agree. The chief culprit, however, is not long-term value creation but its antithesis: "short-termism." Managers and investors alike too often fixate on short-term performance metrics, particularly earnings per share, rather than on the creation of value over the long term. In prioritizing (or, perhaps more correctly, mischaracterizing) shareholders' best interests by focusing almost exclusively on beating analyst estimates of near-term quarterly earnings, the financial system can seem to institutionalize a model that cares only for today and all but ignores tomorrow. There also is evidence, including the median scores of companies tracked by McKinsey's Corporate Horizon Index from 1999 to 2017, that the tendency toward short-termism has been on the rise.

[1] An annual Gallup poll in the United States showed that the percentage of respondents with "little" or "no confidence" in big business increased from 27 percent in 1997 to 34 percent in 2019 and of those with "a great deal" or "quite a lot" of confidence in big business decreased by five percentage points over that period, from 28 percent to 23 percent. Conversely, the percentage of those with "a great deal" or "quite a lot" of confidence in small business *increased* by five percentage points over the same period (from 63 percent in 1997 to 68 percent in 2019). See "Confidence in institutions," Gallup, news.gallup.com.

[2] George Monbiot, "Capitalism is destroying the Earth. We need a new human right for future generations," *Guardian*, March 15, 2019, theguardian.com.

[3] "Statement on the purpose of a corporation," Business Roundtable, August 19, 2019, businessroundtable.org.

Certainly, the roots of short-termism are deep and intertwined. A collective commitment of business leaders to clear the weeds and cultivate future value is therefore highly encouraging.

Companies that conflate short-termism with value creation often put both shareholder value and stakeholder interests at risk. Banks that confused the two in the first decade of this century precipitated a financial crisis that ultimately destroyed billions of dollars of shareholder value. Companies whose short-term focus leads to environmental disasters also destroy shareholder value, not just directly through cleanup costs and fines, but via lingering reputational damage. The best managers don't skimp on safety, don't make value-destroying decisions just because their peers are doing so, and don't use accounting or financial gimmicks to boost short-term profits. Such actions undermine the interests of shareholders and all stakeholders and are the antithesis of value creation.

Value creation is inclusive

For companies anywhere in the world, creating long-term shareholder value requires satisfying other stakeholders as well. You can't create long-term value by ignoring the needs of your customers, suppliers, and employees. Investing for sustainable growth should—and often does—result in stronger economies, higher living standards, and more opportunities for individuals. It should not be surprising, then, that value-creating capitalism has served to catalyze progress, whether by lifting millions of people out of poverty, contributing to higher literacy rates, or fostering innovation that improves quality of life and lengthens life expectancy.

A strong environmental, social, and governance (ESG) proposition also creates shareholder value.[4] For example, Alphabet's free suite of tools for education, including Google Classroom, not only seeks to help equip teachers with resources to make their work easier and more productive but also can familiarize students around the world with Google applications—especially those in underserved communities who might otherwise not have access to meaningful computer engagement at all. Also, Alphabet is not reticent about choosing not to do business in instances that it deems harmful to vulnerable populations: the Google Play app store now prohibits apps for personal loans with exorbitant annual percentage rates, an all-too-common feature of predatory payday loans.[5]

Investing for sustainable growth should—and often does—result in stronger economies, higher living standards, and more opportunities for individuals.

[4] Sheila Bonini, Tim Koller, and Philip H. Mirvis, "Valuing social responsibility programs," *McKinsey Quarterly*, July 2009, McKinsey.com; Witold Henisz, Tim Koller, and Robin Nuttall, "Five ways that ESG creates value," *McKinsey Quarterly*, November 2019, McKinsey.com.
[5] Yuka Hayashi, "Google shuts out payday loans with app-store ban," *Wall Street Journal*, October 12, 2019, wsj.com.

Similarly, Lego's mission to "play well"—to use the power of play to inspire "the builders of tomorrow, their environment and communities"—has led to a program that unites children in rural China with their working parents. Programs such as these no doubt play a role in burnishing Lego's brand throughout communities and within company walls, where it reports that employees' motivation and satisfaction levels beat 2018 targets by 50 percent. Or take the efforts of Sodexo, the French food-services and facilities-management company, to encourage gender balance among managers. Sodexo says the program has increased the retention of not only employees (by 8 percent) but also clients (by 9 percent) and has boosted operating margins (by 8 percent), as well.[6]

Shareholders and stakeholders: A balanced approach

Inevitably, there will also be times when the interests of all of a company's stakeholders are not complementary. Strategic decisions of all kinds involve myriad trade-offs, and the reality is that the interests of different groups can be at odds with one another. Implicit in the Business Roundtable's 2019 statement of purpose is concern that business leaders have skewed some of their decisions too much toward the interests of shareholders.

Stakeholders for the long term

Time will tell how businesses act on this conviction. As a starting point, we'd encourage leaders, when there are trade-offs to be made, to prioritize long-term value creation, given the advantages it holds for resource allocation and economic health. Consider employee stakeholders. A company that tries to boost profits by providing a shabby work environment, underpaying employees, or skimping on benefits will have trouble attracting and retaining high-quality employees. Lower-quality employees can mean lower-quality products, reduced demand, and damage to brand reputation. More injury and illness can invite regulatory scrutiny and more union pressure. Higher turnover will inevitably increase training costs. With today's mobile and educated workforce, such a company would struggle in the long term against competitors offering more attractive environments. If a company earns more than its cost of capital, it might afford to pay above-market wages and still prosper, and treating employees well can be good business.

How well is well enough? A long-term value-creation focus suggests paying wages that are sufficient to attract quality employees and keep them happy and productive—and pairing those wages with a range of nonmonetary benefits and rewards. Even companies that have shifted the manufacturing of products, such as clothing and textiles, to low-cost countries with weak labor protection have found that they need to monitor the working conditions of their suppliers or face a consumer backlash.

Or consider how high a price a company should charge for its products. A long-term approach would weigh price, volume, and customer satisfaction to determine a price that creates sustainable value. That price would have to entice consumers to buy the products more than once: multiple times, for different generations of products. The company might still thrive at a lower price point, but there's no way to determine whether the value of a lower price is greater for consumers than the value of a higher price is for shareholders—and indeed, for all corporate stakeholders—without taking a long-term view.

Social consequences

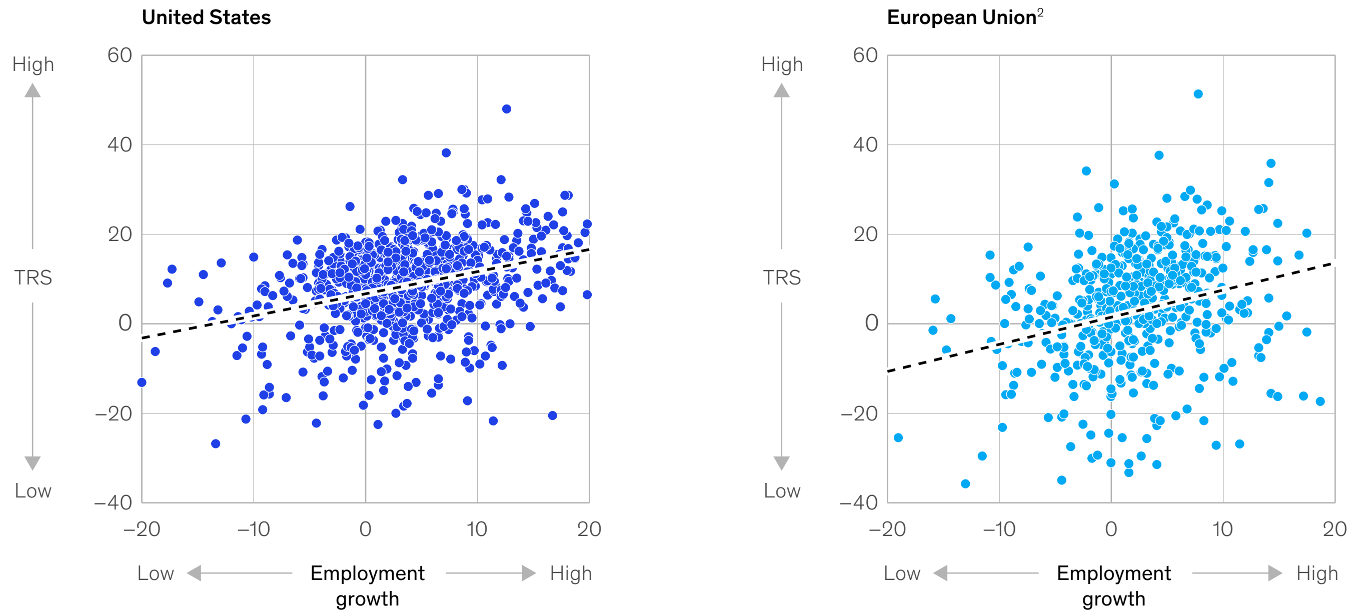
Often, the lines are grey, not black or white. Companies in mature, competitive industries, for example, grapple with whether they should keep open high-cost plants that lose money just to keep employees working and prevent suppliers from going bankrupt. To do so in a globalizing industry would distort the allocation of resources in the economy, notwithstanding the significant short-term local costs associated with plant

[6] *Diversity & inclusion at Sodexo: Making a world of difference*, Sodexo, 2018, sodexo.com.

Exhibit

There is a correlation between total returns to shareholders and employment growth.

Compound annual growth rate, 2007–17, %[1]



[1] Sample includes companies with real revenues >$500 million and excludes outliers with >20% employment growth.
[2] Sample includes companies in the core 15 EU member states.

closures. At the same time, politicians on both sides of the aisle pressure companies to keep failing plants open. Sometimes, the government is also a major customer of the company's products or services.

In our experience, managers not only carefully weigh bottom-line impact but also agonize over decisions that have pronounced consequences on workers' lives and community well-being. But consumers benefit when goods are produced at the lowest possible cost, and the economy benefits when operations that become a drain on public resources are closed and employees move to new jobs with more competitive companies. And while it's true that employees often can't just pick up and relocate, it's also true that value-creating companies create more jobs. When examining employment, we found that the European and US companies that created the most shareholder value in the past 15 years have shown stronger employment growth (exhibit).[7]

Value creation is not a magic wand

Long-term value creation has historically been a massive force for public good, just as short-termism has proved to be a scourge. But short-termism isn't the only source for today's sense of crisis. Imagine, in fact, that short-termism were magically cured. Would other foundational problems suddenly disappear as well? Of course not. There are many trade-offs that company managers struggle to make for which neither a shareholder nor a stakeholder approach offers a clear path forward. This is especially true when it comes to issues

[7] We have performed the same analyses for 15- and 20-year periods, and with different start and end dates, and have always found similar results.

affecting people who aren't immediately involved with the company. These so-called externalities—perhaps most prominently, a company's carbon emissions affecting parties that otherwise have no direct contact with the company—can be extremely challenging for corporate decision making because there is no objective basis for making trade-offs among parties.

That's not to say business leaders should just dismiss the problem of externalities as insolvable or something to be solved on a distant day. Punting is the essence of short-termism. With respect to the climate, some of the largest energy companies in the world, including BP and Shell, are taking bold measures right now toward carbon reduction, including tying executive compensation to emission targets.

Still, the complexity is obvious for any individual company striving to solve comprehensively the global threats, such as climate change, that will affect so many people, now and in the future. That places bigger demands on governments and investors. Governments can create incentives, regulations, and taxes that encourage a migration away from polluting sources of energy. Ideally, such approaches would work in harmony with market-oriented approaches, allowing creative destruction to replace aging technologies and systems with cleaner and more efficient sources of power. This trading off of different economic interests and time horizons is precisely what people charge their governments to do.

Institutional investors, such as pension funds, as stewards of the millions of men and women whose financial futures are often at stake, can also play a critical supporting role. In the case of climate change, longer-term investors concerned with environmental issues, such as carbon emissions, water scarcity, and land degradation, are connecting value and long-term sustainability. Indeed, investor scrutiny has been increasing. Long-term-oriented companies must be attuned to the changes that will be demanded by both investors and governments so they can adjust their strategies over a five-, ten-, or 20-year time horizon and reduce the risk of stranded assets, or those that are still productive but not in use because of environmental or other issues.

Unfortunately, governments and long-term investors don't always play their roles effectively. Breakdowns can lead to divergences between shareholder value creation and the impact of externalities. Failure to price or control for externalities will also lead to a misallocation of resources. Those effects can create new stresses—and sometimes, outright divisions—between shareholders and other stakeholders.

Yet as the Business Roundtable statement affirms, the interests of shareholders and stakeholders can go hand in hand. Businesses can make a vital contribution to preserving those interests by creating value for the long term. Doing so in a sustainable manner calls for meeting the concerns of communities (including those about the environment), consumers, employees, suppliers, and shareholders alike. A short-term focus necessarily short-changes some or all of these constituencies. A long-term commitment toward value creation, by contrast, almost axiomatically takes a broad range of constituent interests into account. Of course, it's not the cure for all social ills (beware of anything that purports to be). But a commitment to long-term value creation is something worth valuing indeed.

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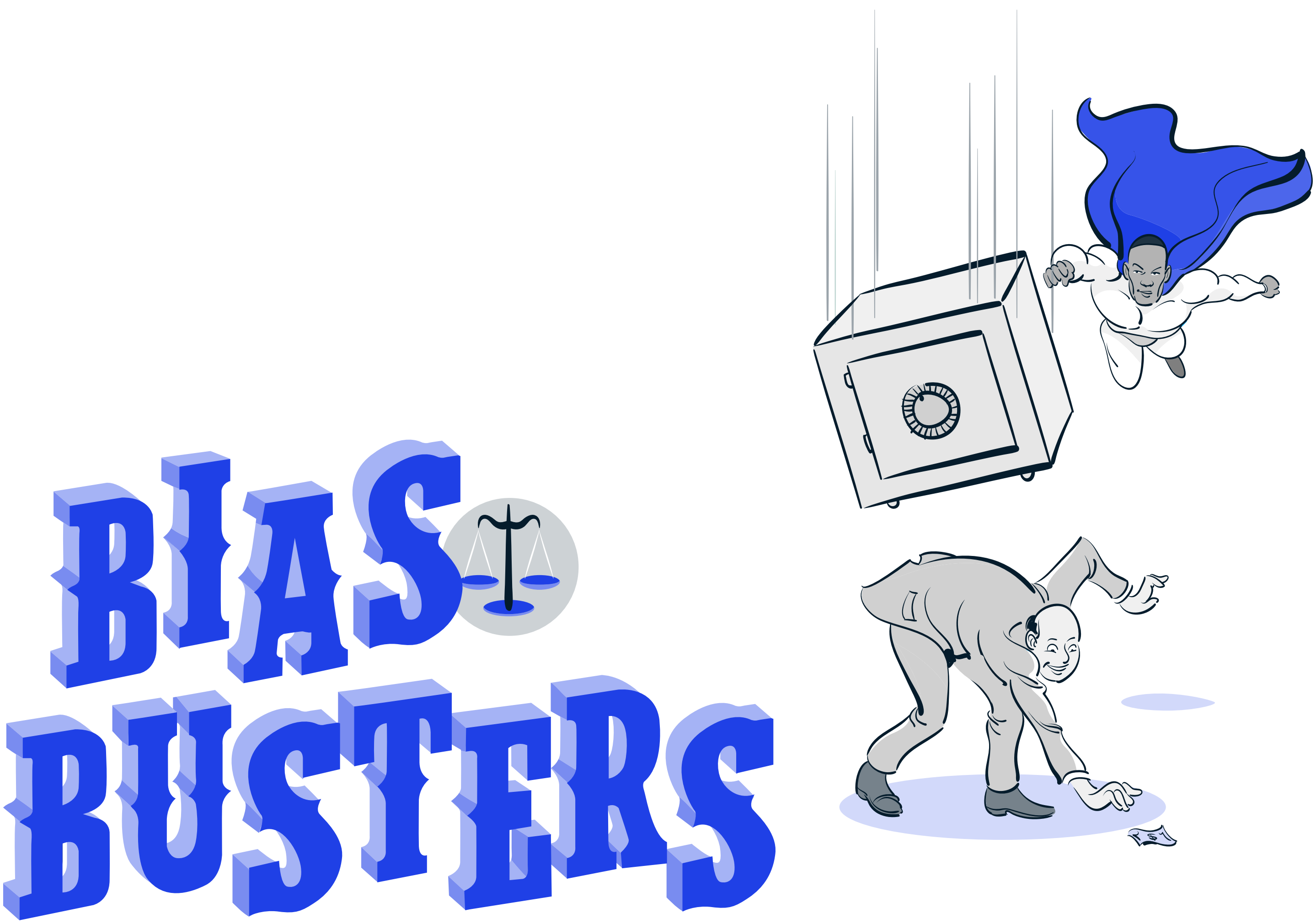
Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

Avoiding snap judgments

by Tim Koller, Dan Lovallo, and Phil Rosenzweig



The dilemma

The board of a mining company thinks it's time for a new CEO, one who understands the increased role of technology in the industry and can inspire the next generation of mining leaders. The hiring committee has a few internal candidates in mind—namely, the heads of the copper, nickel, and coal divisions. All three have similar years and types of industry experience and comparable P&L responsibilities. But the front-runner in the minds of many on the committee is the head of the copper division. After all, copper has contributed the most to the bottom line over the past few years, while the other divisions have been lagging. It must be because the unit head is a tech-savvy people person, with a good understanding of industry trends, they reason. "Seems like a no-brainer," the head of the hiring committee notes. But how can the board be sure that it is picking the best candidate for the top job?

The research

Important personal and professional choices are often subject to the *halo effect*, which is the tendency for individuals to make specific judgements based on overall impressions.[1] Individuals' desire for excessive coherence (or fitting complicated ideas into simple mental frames) also prompts them to draw conclusions faster than they should. It's a common dynamic. The media, for instance, pays outsize attention to companies with remarkably good (or notably bad) performance and tries to offer logical explanations for their outcomes, even when the reality is much more nuanced and intricate.

These distortions don't apply only to company performance; the halo effect can also alter how we view individual performance. That's what happened in the case of the mining company. The leading CEO candidate's division had performed well in large part because of a significant spike in the price of copper, something over which he had no control. Yet the halo of high profits shone on the business-unit leader, the hiring committee's initial impressions of him stuck, and he was appointed CEO. Much to the board's dismay, the new CEO did not demonstrate either skillful use of technology or strong leader-ship, two capabilities that were critical for the role. Early in his tenure, the company incurred billions of dollars in losses.

The remedy

When it comes to hiring decisions, structured interviews can help mitigate the halo effect. They've been shown to increase the validity of interviews significantly.[2] Candidates are measured against

Individuals' desire for excessive coherence (or fitting complicated ideas into simple mental frames) prompts them to draw conclusions faster than they should.

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[1] The concept was first identified in 1920 by US psychologist Edward Thorndike.

[2] See James E. Campion, Michael A. Campion, and David K. Palmer, "A review of structure in the selection interview," *Personnel Psychology*, September 1997, Volume 50, Number 3, pp. 655–702, onlinelibrary.wiley.com; and Philip A. Lichtenfels, Elliot D. Pursell, and Patrick M. Wright, "The structural interview: Additional studies and a meta analysis," *Journal of Occupational Psychology*, September 1989, Volume 62, Issue 3, pp. 191–99, onlinelibrary.wiley.com.

valid indicators—the attributes and experiences defined as being most important for success in the position. (For C-suite-level roles, in particular, leadership attributes and experiences typically matter more than knowledge and skills.) All three CEO candidates at the mining company, for instance, might have been asked specific questions about their experiences in dealing with new technologies or resource shortages and surpluses. All should have been subject to the exact same criteria and questions. Then each could have been scored, criterion by criterion, using a standardized rating scale before an overall evaluation was made. Only then should the hiring committee have discussed the relative merits of the three candidates. The structured interview does not prohibit the use of executive intuition, but it can usefully delay it.

Executives can reduce the impact of the halo effect in other types of business decisions by first acknowledging their intuitions and then taking a minute to ask themselves, "What sort of judgment would I make if I set aside my first impressions?" It's the mental equivalent of a blind taste test, where consumers are asked about products whose brand names have been removed: without the strong glow of a brand's halo, consumers can say what they really think.

Whether executives are facing hiring decisions or other important choices, they need to make judgments based on evidence that is independent and valid, not merely inferred from what they already know—or think they know.

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